Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Return of capital

Certain types of investments may make return of capital (ROC) distributions to you. ROC represents a return of all or a portion of your original invested capital and thus generally isn't immediately taxable to you. This article describes the types of investment vehicles that may make ROC distributions and explains the tax implications of receiving ROC distributions.

What are the benefits of ROC?

ROC distributions provide three key benefits:

Tax efficiency: Unlike interest, dividends and capital gains, distributions classified as ROC are generally not taxable in the year they're received.

Cash flow stability: Investments that distribute ROC are particularly appealing if you're seeking regular cash flow from your portfolios. ROC is typically used to help fund managers distribute a predictable monthly cash flow.

Tax deferral: Tax associated with the investment may be deferred until you sell the investment, helping you maximize your current cash flow.

ROC investment vehicles

There are several types of investment vehicles that can make ROC distributions to you. These include but are not limited to: certain mutual funds, exchange-traded funds (ETFs), real estate investment trusts (REITs), and limited partnerships (LPs).

Mutual funds

ROC distributions typically occur when a fund's objective is to pay a set monthly or annual distribution. If the fund earns income (i.e. interest, dividends and/or realized capital gains) that's less than the set distribution amount, ROC is used to make up the remainder of the distribution. This means some of the fund's original capital is returned to you in order to cover the distribution.

ETFs

Like a mutual fund, an ETF may distribute ROC to its unitholders to ensure the unitholders receive a certain amount of income from the fund. An ETF may also flow out ROC distributions it's received from its own underlying investments to its unitholders.

REITs

An REIT is allowed certain tax deductions, such as depreciation. These deductions result in a lower taxable income for the REIT but do not reduce the cash available for distributions. This permits the

REIT to make cash distributions to you in excess of its income. Any distribution in excess of the REIT's net income represents ROC.

LPs

An LP will generally not pay tax on the income it earns. Instead, the LP will allocate its income less any expenses to its partners or investors. This allocation is known as net allocated income. Any cash distributions you receive from the LP in excess of the LP's net allocated income represents ROC.

ROC taxation

It's important to understand the long-term tax impact of ROC distributions. ROC distributions are generally not taxable in the year you receive them. Instead, any ROC distributions you receive reduce the adjusted cost base (ACB) of your investment for tax purposes. This will typically result in a larger capital gain or a smaller capital loss when you eventually dispose of your investment.

If the ACB of your investment is reduced below zero during the tax year, the negative amount is immediately deemed a capital gain in the year it occurs and the ACB of your investment is deemed zero.

Tax reporting

Certain types of investments may make distributions to you throughout the year. However, the income sources that make up the distribution (i.e. interest, dividends, capital gains and/or ROC) may not be known at the time of the payment. The amount of ROC for the year will only be known once the investment calculates its annual income, generally early in the following year. After the calculations are completed, the investment will report the makeup of any distributions you received on a T3, *Statement of Trust Income Allocations and Designations*, or T5, *Statement of Investment Income*, reporting slip.

You're not required to report ROC distributions on your tax return, but you should keep track of ROC payments to accurately calculate the ACB of your investments. Keep in mind that if the ACB of your investment becomes negative, the negative amount is taxable as a capital gain for the year. You also need to maintain the correct ACB in order to calculate your gain or loss when you eventually sell the investment.

Other ROC considerations

Government income-tested benefits

Certain government benefits, such as Old Age Security (OAS) and the age amount tax credit, are income-tested benefits. In other words, these benefits are reduced if your income exceeds a certain threshold. Amounts that affect government income-tested benefits typically include pension income, investment income and taxable capital gains. Since ROC distributions aren't considered taxable income, these income-tested benefits will not be affected by ROC distributions. However, keep in mind that when you decide to sell your investment, these benefits may be impacted by the potentially larger capital gain.

Interest deductibility

When you borrow money to put into an investment that returns capital to you, you should be aware of the interest deductibility rules. If you don't plan on reinvesting your ROC distributions, you may no longer be able to fully deduct the interest for tax purposes. Since an ROC distribution represents a return of all or a portion of your original invested capital, the portion of the interest that relates to the ROC distribution will not be deductible if you use the distribution for personal purposes (e.g. vacation, clothing). Alternatively, if you reinvest the ROC payment to acquire more income-producing investments, you may continue deducting the interest.

It's important to note that using borrowed money to finance the purchase of investments involves greater risk than a purchase using cash resources only. If you borrow money to purchase investments, your responsibility to repay the loan as required by its terms remains the same, even if the value of the investments purchased declines. You should obtain professional advice from a qualified tax advisor before implementing any borrowing-to-invest strategy.

Conclusion

If you're planning to purchase or you already own investments that may make ROC distributions, it's important to understand how these distributions affect your financial situation. While the immediate tax-free nature of ROC distributions is attractive, keep in mind there are future tax implications associated with these distributions. Speak with your RBC advisor about whether these investments are right for you.

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